TESTIMONY

OF

PAUL F. ROYE
DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
THE MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003, H.R. 2420

BEFORE THE HOUSE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES, COMMITTEE ON FINANCIAL SERVICES

JUNE 18, 2003

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

On behalf of the Securities and Exchange Commission (the "Commission"), I am pleased to discuss H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003," (the "Bill"), which recently was introduced by Chairman Baker and co-sponsored by several members of the Subcommittee. It is both a pleasure and an honor to testify before you today.

This Bill can provide investors with important information regarding their investments in mutual funds, as well as strengthen the corporate governance standards of mutual funds. In addition to providing mutual fund investors with disclosures about estimated operating expenses incurred by shareholders, soft dollar arrangements, portfolio transaction costs, sales load breakpoints, directed brokerage and revenue sharing arrangements, the Bill also would require disclosure of information on how fund portfolio managers are compensated and require fund advisers to submit annual reports to fund directors on directed brokerage and soft-dollar arrangements, as well as revenue sharing. It also would recognize fiduciary obligations of fund directors to supervise these activities and assure that they are in the best interest of the fund and its shareholders. In addition, the Bill would require the Commission to conduct a study of soft dollar arrangements to assess conflicts of interest raised by these arrangements and examine whether the statutory safe harbor in section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act") should be reconsidered or modified.

As discussed in more detail below, we support the goals of the Bill and commend Chairman Baker and the co-sponsors of this legislation for their initiative and support of a regulatory regime that best serves the interests of mutual fund investors. We particularly support the goals of enhancing disclosure and the expanded authority the Bill would provide the Commission to define which directors can be considered independent. With respect to some other provisions, while supporting the goals, the Commission believes the Bill should preserve the Commission's flexibility to determine appropriate standards through the notice and comment rulemaking process. Overall, this Bill has the potential to assist in maintaining investor confidence in the fairness of the operations of mutual funds – the investment of choice for millions of Americans.

I. <u>Improved Transparency of Mutual Fund Costs</u>

Section 2(a) of the Bill would require the Commission to revise regulations under the Securities Act of 1933 ("Securities Act"), the Exchange Act, or the Investment Company Act of 1940 ("Investment Company Act"), or any combination thereof, to require improved mutual fund disclosure. The Commission supports the goals of this provision of the Bill, which would increase the transparency of costs and other information to mutual fund investors. The Commission has long been committed to full disclosure of mutual fund costs and other key information so that investors may make informed decisions. We believe that the Bill represents a step in improving the disclosure that mutual fund investors receive about their funds.

Improved disclosure in these areas will support the current lynchpin of a mutual fund's cost disclosure – the standardized fee table – which the Commission has required in every mutual fund prospectus since 1988.[1] The Bill would require improved disclosure of mutual fund costs and provide key information to investors as outlined below.

A. Dollar Disclosure of Operating Expenses Borne by Shareholders

The Bill would require improved disclosure of the estimated amount, in dollars, of a mutual fund's operating expenses that are borne by each shareholder. This should help to address ongoing concerns that fund investors may not understand the nature and long-term effect of recurring mutual fund fees. By requiring that the disclosure be provided in dollar terms, rather than just as a percentage of net assets, the Bill should help investors to understand, in very practical terms, the impact of fund expenses on the value of their investments.

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1 Item 3 of Form N-1A. The table reflects both (i) transactional fees, *i.e.*, charges paid directly by a shareholder out of his or her investment, such as front- and back-end sales loads, and (ii) recurring charges deducted from fund assets, such as management fees and 12b-1 fees. The table is located at the beginning of the prospectus. It is accompanied by a numerical example that illustrates the total dollar amounts, including both transactional costs paid directly by a shareholder and ongoing asset-based expenses, that an investor could expect to pay on a $10,000 investment if the fund achieved a 5% annual return and the investor remained invested in the fund for 1-, 3-, 5-, and 10-year periods.

Despite existing disclosure requirements, as well as educational efforts,[2] the degree to which investors understand mutual fund fees and expenses remains a significant source of concern. While transactional fees, such as front- and back-end sales loads, are relatively transparent, portfolio transaction costs, such as management fees and distribution fees, are less evident because they are deducted directly from fund assets. These charges are reflected in reduced account balances and expressed as a percentage of net assets in a fund's prospectus, making their impact less evident to an investor. Surveys have indicated that investors may not understand the nature and effect of these recurring mutual fund fees.[3]

In December 2002, the Commission proposed new disclosure requirements that would achieve the same objectives as proposed in the Bill and are intended to increase investors' understanding of the recurring expenses that they pay to invest in a fund. Specifically, the Commission proposed to require mutual funds to disclose in their annual and semi-annual reports to shareholders fund expenses borne by shareholders during the reporting period. Under the Commission's proposal, fund shareholder reports would be required to include: (i) the cost in dollars associated with an investment of $10,000, based on the fund's actual expenses and return for the period; and (ii) the cost in dollars,

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2 In 1999, for example, the Commission introduced the Mutual Fund Cost Calculator, an Internet-based tool available on the Commission's website that enables investors to compare the costs of owning different mutual funds over a selected period. SEC Mutual Fund Cost Calculator <http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm> (last modified July 24, 2000).

3 Securities and Exchange Commission and Office of the Comptroller of the Currency, *Report on the OCC/SEC Survey of Mutual Fund Investors*, at 14-15 (June 26, 1996). The report found that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns. A recent survey found that 75% of respondents could not accurately define a fund expense ratio and 64% did not understand the impact of expenses on fund returns. *See Investors Need to Bone Up on Bonds and Costs, According to Vanguard/MONEY Investor Literacy Test*, Press Release, BUSINESS WIRE, Sept. 25, 2002.

associated with an investment of $10,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year.[4] The first figure is intended to permit investors to estimate the actual cost, in dollars, that they bore over the reporting period. The second figure is intended to provide investors with a basis for comparing the level of current period expenses at different funds. The Commission staff is currently reviewing the comments on the proposal and expects to present the Commission with a recommendation in this area expeditiously.

B. Portfolio Manager Compensation

The Bill would require improved disclosure of the structure of, or method used to determine, the compensation of individuals employed by a mutual fund's investment adviser to manage the fund's portfolio. Mutual funds typically are externally managed by an investment adviser, to which they pay an advisory fee directly from fund assets. The investment adviser in turn employs the individuals who act as portfolio managers. Commission rules currently require a fund to provide disclosure only of the amount of the advisory fee paid to the investment adviser in the fee table in the fund's prospectus.[5]

Disclosure regarding the structure of an individual portfolio manager's compensation would be useful in supplementing existing disclosure of the advisory fee.

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4 Investment Company Act Release No. 25870 (Dec. 18, 2002).

5 Item 3 and Instruction 3(a) to Item 3 of Form N-1A. In addition, the prospectus must include a description of the investment adviser's compensation, including the aggregate fee paid to the adviser for the most recent fiscal year as a percentage of average net assets. *See* Item 6(a)(1)(ii)(A) of Form N-1A. If the fee is not based on a percentage of average net assets, *e.g.*, if the adviser receives a performance-based fee, the prospectus also is required to describe the basis of the adviser's compensation. *See* Item 6(a)(1)(ii)(B) of Form N-1A. Further, a fund is required to provide disclosure in its statement of additional information ("SAI") regarding the method of calculating the advisory fee payable by the fund, including the total dollar amounts that the fund paid to the investment adviser under the investment advisory contract for the last three fiscal years. *See* Item 15(a)(3) of Form N-1A. The SAI is a portion of a fund's registration statement that is not part of the fund's prospectus but is required to be delivered to investors free of charge upon request.

Such disclosure is one way to provide fund shareholders with information that would be helpful in assessing the incentives of the individuals who are managing the fund. For example, disclosure that a manager is compensated based on the fund's performance for a particular period (*e.g.*, 3 months, 1 year, or 5 years) may shed light on the manager's incentives to maximize short-term or long-term performance. Similarly, disclosure of whether a portfolio manager's compensation is based on a fund's pre-tax or after-tax returns would be useful in assessing whether a fund is an appropriate investment for a taxable or tax-deferred account.

C. Portfolio Transaction Costs

The Bill would require improved disclosure of a mutual fund's portfolio transaction costs, including commissions paid with respect to the trading of portfolio securities, set forth in a manner that facilitates comparison among funds. Although transaction costs are currently taken into account in computing a fund's total return, they generally are not included as part of a fund's expense ratio.[6] The improved disclosure of transaction costs that the Bill would require should provide investors with a better understanding of these costs, which are substantial for many funds.

Broadly defined, a mutual fund's transaction costs are the overall costs of implementing the fund's trading strategy.[7] Transaction costs include commissions, spreads, market impact costs, and opportunity costs. Commissions are per share charges

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6 Commission rules, however, require a mutual fund to record as an expense the value of services received under a brokerage service arrangement, pursuant to which a broker agrees to pay certain fund operating expenses and the fund agrees to direct a minimum amount of brokerage to the broker. *See* Regulation S-X, Article 6-07(2)(g).

7 John M.R. Chalmers, Roger M. Edelen and Gregory B. Kadlec, "Mutual Fund Trading Costs," University of Pennsylvania, Rodney L. White Center for Financial Research, Working Paper 027-99, Nov. 2, 1999, at 1.

paid to a broker to act as agent for a customer (the fund) in the process of executing and clearing a trade. Spread costs are incurred indirectly when a fund buys a security from a dealer at the "asked" price (above current value) or sells a security to a dealer at the "bid" price (below current value). The variance from current value is known as the "spread." Market impact costs are incurred when the price of a security changes as a result of the effort to purchase or sell the security. Market impacts are the price concessions (amounts added to the purchase price or subtracted from the selling price) that are required to find the opposite side of the trade and complete the transaction.[8] Opportunity cost is the cost of delayed or missed trades. The longer it takes to complete a trade, the greater the likelihood that someone else will decide to buy (or sell) the stock and, by doing so, drive up (or down) the price.

Commissions are the only type of transaction cost that can be measured directly. Measurement is straightforward because the commission is separately stated as a per share charge on the transaction confirmation and is paid directly from fund assets. Spread, market impact, and opportunity costs, however, can only be estimated.[9] As a result, there is no generally agreed-upon method to calculate overall transaction costs.

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8 *See* Stephen A. Berkowitz and Dennis E. Logue, "Transaction Costs: Much Ado about Everything," 27 JOURNAL OF PORTFOLIO MANAGEMENT 65, 68 (2001).

9 *See* SEC Staff Memorandum in Response to March 26, 2003 Letter from Richard H. Baker, Chairman, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, U.S. House of Representatives, to William H. Donaldson, Chairman, Securities and Exchange Commission, dated June 9, 2003 ("Baker Staff Response") at 22; SEC Staff Memorandum in Response to March 26, 2003 Letter from Representatives Robert W. Ney and Paul E. Kanjorski, Members, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, U.S. House of Representatives, to William H. Donaldson, Chairman, Securities and Exchange Commission, dated June 11, 2003 ("Ney/Kanjorski Staff Response" and, together with the Baker Staff Response, the "Staff Responses"), at 24.

Some have suggested that mutual funds should be required to disclose a quantitative measure of their overall transaction costs.[10] Although proposals to quantify overall transaction costs are attractive in theory, they may not be feasible in practice. Estimates of overall transaction costs appear to lack the attributes of uniformity, reliability, and verifiability.[11] Nonetheless, consistent with the Bill, the Commission believes that investors would benefit from better, more understandable disclosure of transaction costs, set forth in a manner that facilitates comparison among funds.

The Commission believes that a variety of approaches could achieve the objectives of the provision and deserve further consideration. First, because commission costs are identifiable, in terms of cents per share, and because commission rates currently are more transparent, disclosure of the fund's average and range of commission costs would aid in the assessment of soft-dollar arrangements by directors and investors, as discussed in section I.D of this testimony. Further, we could require funds to give greater prominence to the portfolio turnover ratio. This ratio is a relatively good proxy for transaction costs, simple to calculate, relatively straightforward to understand, and subject to comparison across funds. Another approach that deserves consideration is to require all funds to include in the prospectus a discussion of the impact of their investment objectives, strategies, and management style on portfolio turnover and overall transaction costs. Currently, funds are required to discuss the impact of active and frequent portfolio trading, which results in a higher portfolio turnover ratio, only if it is a principal investment strategy. Thus, funds also could be required to give greater

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10 Testimony of John Montgomery, March 12, 2003, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, U.S. House of Representatives.

11 *See* discussions of transaction costs in Staff Responses, *supra* note 9.

prominence to the information on brokerage costs that is currently included in the SAI and this information could be disclosed together with portfolio turnover information in order to give shareholders a more complete understanding of the fund's transaction costs.

D. "Soft Dollar" Arrangements

"Soft dollars" involve a portion of the commission charged to funds (and other investors) for the execution of their portfolio trades, which are directed by the investment manager to brokers who provide services such as investment research and to reward brokers for their sale of fund shares. Soft dollars also may be "recaptured" for the benefit of funds by directing brokers to pay for expenses normally paid by the funds directly (*e.g.*, accounting fees, transfer agency and custodian services).

1. *Soft Dollars for Research*

The use of soft dollars for research should be reviewed and authorized as in the best interests of the fund by the fund's board of directors. The Bill would require improved disclosure of information concerning a mutual fund's policies and practices with respect to certain soft dollar arrangements whereby brokerage commissions are paid to a broker who provides research and other transaction related services. We are concerned about the growth of soft dollar arrangements and the conflicts they may present to money managers, including fund advisers. We agree that fund directors and investors should be provided with better information about soft dollar arrangements.

Soft dollar arrangements involve the potential for conflicts of interest between a mutual fund and its investment adviser, since they involve incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft dollar commitments to brokers.

These types of conflicts generally are monitored and managed by fund boards of directors. Fund independent directors are in a better position to monitor the adviser's direction of the fund's brokerage than are fund investors. As a result, the Commission historically has not required fund prospectuses to disclose specific information about the use of soft dollars. Funds are required, however, to disclose information about soft dollar arrangements in the SAI.[12] We agree that the time has come to consider improving disclosure along the lines suggested by the Bill. While we remain convinced that independent directors are in the best position to monitor the use of a fund's brokerage, investors can benefit from improved information about a fund's policies and practices with respect to soft dollar arrangements. Fund brokerage is an asset of the fund and its shareholders, and those shareholders should be provided with better information about the use of this asset. As described in Section V of this testimony, we also support the Bill's provisions regarding a study of soft dollar arrangements, including the safe harbor created in section 28(e) of the Exchange Act.

2. *Use of Brokerage to Facilitate Distribution of Mutual Fund Shares*

The Bill would require improved information concerning a mutual fund's policies and practices with respect to the payment of brokerage commissions to a broker who facilitates the sale and distribution of the fund's shares. The Commission supports greater transparency in this area, to provide fund investors with better information

12 Item 16 of Form N-1A.

concerning the use of this valuable fund asset to compensate brokers who distribute the fund's shares.

Over the past decade, broker-dealers selling fund shares have increasingly demanded compensation for distributing fund shares that is over and above the amounts that they receive in the form of sales loads and rule 12b-1 distribution fees. Thus, brokers have required payments for "shelf space," that is, for giving "preferred" status to a particular fund group.[13] To meet this demand, fund advisers increasingly have been required to make payments out of their own resources to broker-dealers selling their fund shares ("selling broker-dealers") and have used fund brokerage commissions as additional compensation to these selling broker-dealers.

Funds and their investment advisers use a number of different brokerage commission practices to compensate selling broker-dealers. For example, in some cases, a fund's investment adviser, when selecting among executing broker-dealers will consider, among other things, sales of the fund's shares by the executing broker-dealer.[14] In other arrangements, a fund's investment adviser places an order to buy or sell portfolio securities with a selling broker-dealer and the selling broker-dealer then forwards, or introduces, the trade to another broker-dealer, who then executes the trade. In such cases, the selling broker-dealer may or may not provide any execution services in connection

13 "Preferred" status may involve priority on the broker's list of recommended funds, access by the fund distributors to the broker's sales force, and appearances at broker-sponsored retreats and seminars.

14 NASD Conduct Rule 2830(k)(7)(B) permits a broker-dealer to sell to its customers the shares of a fund that follows a policy of considering past sales of fund shares in selecting broker-dealers to execute portfolio transactions, subject to the requirements of best execution.

with the trade and part of the commission paid is used to compensate the selling broker-dealer for selling fund shares.[15]

The Commission supports the Bill's goal of improved information concerning a mutual fund's policies and practices with respect to the payment of brokerage commissions to a broker who facilitates the sale and distribution of the fund's shares. A fund's brokerage commissions are a valuable asset of the fund and its shareholders, and we believe fund investors are entitled to greater transparency with respect to the use of those commissions to facilitate the sale of fund shares.

E. Revenue Sharing

The Bill would require improved disclosure of information concerning "revenue-sharing" payments by persons other than a mutual fund, *e.g*, the fund's investment adviser and its affiliates, that are intended to facilitate the sale and distribution of the fund's shares. The Commission has previously recognized that this area deserves further consideration and has directed the staff to make recommendations regarding improved disclosure of revenue-sharing payments.[16] Accordingly, the Commission supports the legislation in this area.

As a general matter, many funds compete intensely to secure a prominent position in the distribution systems that selling broker-dealers maintain for distributing fund shares. As noted earlier, selling broker-dealers have increasingly demanded

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15 As discussed in the Staff Responses, certain of these arrangements raise issues under rule 12b-1 under the Investment Company Act, when fund brokerage commissions are used to reward brokers for distribution without appropriate compliance with the rule.

16 *See Press v. Quick & Reilly, Inc.,* 218 F.3d 121, 132 n.13 (July 10, 2000) ("Press v. Quick & Reilly"). *See also* Brief of the Securities and Exchange Commission, Amicus Curiae, in *Cohen, et al. v. Donaldson, Lufkin & Jenrette Securities Corp., et al.* No. 97-9159 (2d Cir.) (Feb. 2000) ("Amicus Brief").

compensation for distributing fund shares that is in addition to the amounts that they receive from sales loads and 12b-1 fees. To meet this demand, fund investment advisers have increasingly made revenue-sharing payments to the selling broker-dealers.

"Revenue-sharing" payments are not a fund expense because they are made from the adviser's own resources, rather than fund assets. As a result, mutual funds are not required to disclose these payments,[17] however, at some point, as demands escalate, the manager may be tempted to ask for an increase in its fees from the fund.

Broker-dealers, however, are required to disclose their receipt of revenue-sharing payments to their customers that purchase fund shares. A broker-dealer generally is required, by Rule 10b-10 under the Exchange Act, to disclose to its customer, in writing, at or before the completion of a transaction, that it has received or will receive compensation from a third party for effecting the transaction for the customer. In particular, any broker-dealer that effects a purchase of fund shares for a customer must disclose to the customer the source and amount of any revenue-sharing payments that the broker-dealer receives, or will receive, from the fund's investment adviser.[18] A broker-dealer may satisfy this disclosure obligation by, among other things, delivering to its customer a copy of the fund's prospectus, at or before completion of the transaction, if the prospectus contains adequate disclosures.[19] Many funds disclose in their prospectuses general information about their investment advisers' revenue-sharing payments to broker-

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[17] As discussed above, a mutual fund is required to disclose in its prospectus the fees that it pays to its investment adviser.

[18] Rule 10b-10 under the Exchange Act.

[19] *See* Securities Confirmations, Securities Exchange Act Release No. 13508 at n.41 (May 5, 1977). *See also* Amicus Brief, *supra* note 16.

dealers, which in some cases has the effect of facilitating the broker-dealers' compliance with that obligation. Many funds also disclose certain additional details about revenue-sharing payments made by their investment advisers in their SAIs.

The Commission has recognized, however, that fund prospectuses are not designed to make the particular disclosures that broker-dealers must provide to their customers about their receipt of revenue-sharing payments to meet the requirements of rule 10b-10 under the Exchange Act. Indeed, consistent with the Bill, the Commission has directed its staff to make recommendations as to whether additional disclosure should be required or current disclosure further refined.[20]

F. Breakpoint Disclosure

The Bill would require improved disclosure of information concerning available discounts on front-end sales loads, including the minimum purchase amounts required for such discounts. We believe that this improved disclosure could be helpful to investors in determining discounts to which they are entitled.

Many mutual funds offer shares subject to front-end sales loads. These sales loads are expressed as a percentage of the purchase price of the funds' shares and are paid to broker-dealers that sell those shares. Funds frequently offer discounts on front-end sales loads based on breakpoints that are linked to the dollar amounts of the purchases.[21] Funds that offer breakpoint discounts must disclose the breakpoints and related

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[20] *See* Press v. Quick & Reilly, *supra* note 16 at 132 n.13. *See also* Amicus Brief, *supra* note 16.

[21] For example, a fund may offer shares subject to a front-end sale load equal to 5% for purchase amounts up to $50,000, 4% for purchase amounts between $50,000 and $100,000, 3% for purchase amounts between $100,000 and $250,000, and so on until the front-end sales load is reduced to 0% for purchase amounts over $1 million. *See Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds* (March 2003) ("Staff Breakpoint Report") <http://www.sec.gov/news/studies/breakpointrep.htm>.

procedures in their offering documents.[22] Some funds disclose breakpoints in their prospectuses, while many others do so in the SAI.

The staffs of the Commission, the National Association of Securities Dealers ("NASD"), and the New York Stock Exchange ("NYSE") recently conducted examinations of 43 broker-dealers that sell funds that offer shares subject to front-end sales loads.[23] The purpose of the examinations was to determine whether investors were receiving the benefit of available breakpoint discounts on funds that offer shares subject to front-end sales loads. The Commission, NASD, and NYSE examiners reviewed thousands of fund transactions and found significant failures by the broker-dealers to deliver breakpoint discounts to eligible customers.

We believe that improved disclosure to investors of available breakpoint discounts, as the Bill would require, would help investors to monitor whether they are receiving the discounts to which they are entitled.[24]

G. Location of Disclosure

Section 2(a) of the Bill provides that the Commission require improved disclosure of the above matters in a mutual fund's quarterly statement, periodic report to shareholders, or other appropriate disclosure document. Section 2(b) provides that a

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22 Items 8(a)(1) & (2) of Form N-1A.

23 *See* Staff Breakpoint Report, *supra* note 21, at 10.

24 *See* Letter from Harvey L. Pitt, Chairman, SEC, to Robert R. Glauber, Chairman and Chief Executive Officer, NASD, Matthew P. Fink, President, Investment Company Institute, and Marc E. Lackritz, President, Securities Industry Association (Jan. 15, 2003). *See also* NASD News Release dated February 18, 2003. As part of the Commission's review of the breakpoint issue, the NASD convened a task force comprised of regulators and representatives from broker-dealers, funds, fund administrators, and operational personnel to review solutions to help ensure that mutual fund investors receive the breakpoints to which they are entitled. The task force has met several times, and it is expected that it will formulate recommendations, both for regulatory action and voluntary industry measures, that can minimize problems in this area.

disclosure is not considered to be made in an appropriate disclosure document if the disclosure is made exclusively in a prospectus or statement of additional information, or both such documents.

While we support improved disclosure of mutual fund costs and related matters, the Commission believes that the Bill should preserve the Commission's flexibility to determine the appropriate disclosure document or documents for each of the mandated disclosures and not preclude any particular document. Broad public input would be extremely useful in assessing the benefits (*e.g*, accessibility and understandability to investors) and costs (*e.g.*, needed systems changes, printing, and mailing) of each potential disclosure location.

II. Distribution and Soft Dollar Arrangements

Section 3 of the Bill would amend section 15 of the Investment Company Act to require each adviser to an investment company to submit to the fund's board of directors a report on three types of common arrangements that raise significant issues in the management of an investment company. The report would cover:

- Revenue sharing arrangements, in which the adviser (or one of its affiliated persons) makes payments out of its own resources to promote the sale of fund shares;

- Directed brokerage arrangements, in which the fund obtains payments or services as a result of the adviser's direction of its brokerage transactions; and

- Soft dollar arrangements, in which the fund's adviser obtains research services from brokers in return for the direction of fund brokerage transactions.

Section 3 of the Bill also recognizes fund boards' fiduciary obligation to supervise the adviser's direction of fund brokerage transactions, including soft dollar and directed brokerage arrangements, and to determine that they are in the best interests of fund shareholders. In the case of revenue sharing arrangements, section 3 would require the board to determine that they are in compliance with the Investment Company Act and Commission rules, and also that they are in the best interests of fund shareholders. Finally, the section directs the Commission to adopt rules to implement the section by, for example, specifying the contents of the reports.

The Commission supports these proposed amendments. They acknowledge the important role that fund boards play in the supervision of fund brokerage arrangements by recognizing a federal duty to supervise the adviser's use of the fund's brokerage, and by requiring advisers to provide fund boards with information sufficient to fulfill that obligation and safeguard the interests of fund shareholders. The amendments also add what we believe may be a new duty with respect to scrutinizing revenue sharing arrangements, which as noted above, have become increasingly important in the distribution of fund shares and can raise difficult issues.[25] We agree with the Bill's grant of additional rulemaking authority, which will help the Commission maximize the effectiveness of the provision and resolve questions that may arise.

III. Mutual Fund Governance

Section 4 of the Bill would amend section 10 of the Investment Company Act to increase the number of independent directors who must serve on fund boards by reducing the maximum percentage of board members who may be "interested persons" from 60 percent to one third. As a result, at least two-thirds of a fund's directors would be

[25] We commend the sponsors of the Bill for drawing a distinction between soft dollar arrangements and directed brokerage arrangements, which may involve conflicts of interest, and revenue sharing arrangements, which typically raise questions of whether payments by the adviser are an indirect use of the fund's assets to finance the distribution of its shares and thus must be made in compliance with the requirements of the Commission's rule 12b-1.

required to be independent of fund management. The Commission supports the goal of this amendment, which is to give shareholders a greater voice in how their fund is managed, and is consistent with the best practices adopted by many fund groups.[26] While this could impose additional costs on some funds because they may be required to add additional independent directors, the Advisory Group indicated that the benefits of a two-thirds standard justified their recommendation.[27] Independent directors in many fund groups already constitute more than a majority of the board and a number have boards with only one or two inside directors.

Section 4 of the Bill also would amend section 10 of the Investment Company Act to require that an independent director serve as the chairman of the board of directors. We agree that there may be benefits to having an independent director serve as the board chairman, such as the ability to control boardroom agendas and manage the flow of information to members of the board. We would note, however, that by increasing the representation of independent directors on fund boards, the Bill clearly would empower independent directors to select one of their own as chairman and to use their judgment as to who should serve as chairman.

Finally, section 4 of the Bill would amend section 2(a)(19) of the Investment Company Act to give the Commission rulemaking authority to deem certain persons to be

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[26] *See* Enhancing a Culture of Independence and Effectiveness, Report of the Advisory Group on Best Practices for Fund Directors (the "Advisory Group"), the Investment Company Institute (June 24, 1999)("Advisory Group Report") (recommending that independent directors constitute at least two-thirds of fund boards because a "two-thirds standard will be more effective than a simple majority in enhancing the authority of the independent directors").

[27] *Id.* at 11. In 2001, the Commission adopted rule amendments requiring that a majority of a fund's directors be independent if the fund relies on certain rules that exempt funds from various requirements of the 1940 Act. *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001). Independent directors comprise a majority of most fund boards.

interested persons as a result of certain material business or close familial relationships.[28] We strongly support this amendment, which would permit us to close "gaps" in the Investment Company Act that have permitted persons to serve as independent directors who do not appear to be sufficiently independent of fund management. For example, currently a fund manager's uncle is permitted to serve on the fund's board as an independent director.[29] In other cases, former executives of fund management companies have served as independent directors.[30] Best practice guidelines of the Advisory Group provided that former fund management executives should not serve as independent directors because their prior service may affect their independence, both in fact and in appearance.[31]

IV. <u>Audit Committee Requirements</u>

Section 5 of the Bill would extend to mutual funds certain audit committee requirements similar to those for listed companies required by section 301 of the

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28 Section 2(a)(19) of the Investment Company Act defines the term "interested person" to include the fund's investment adviser, principal underwriter, and certain other persons (including their employees, officers or directors) who have a significant relationship with the fund, its investment adviser or principal underwriter. It also encompasses a broader category of persons having business relationships with the fund or its investment adviser, including certain broker-dealers and persons who have served as counsel to the fund, its investment adviser or principal underwriter within the last two fiscal years of the fund. Finally, section 2(a)(19) provides the Commission authority to issue an order deeming a natural person to be an "interested person" as a result of certain material business relationships occurring within the last two fiscal years of the fund.

29 S*ee* Aaron Lucchetti, *SEC Backs Role of Uncle as Director*, Wall St. J., Nov. 11, 1999 at C1.

30 Section 2(a)(19) of the Investment Company Act permits a fund executive to serve as an independent director two years after his or her retirement.

31 *See* Advisory Group Report, *supra* note 26, at 12-13. The Advisory Group Report recommended that former officers or directors of a fund's investment adviser, principal underwriters or certain of their affiliated persons not serve as independent directors. It believed that such a standard "provides more meaningful assurance of directors' independence and enhances the overall credibility of the system of independent directors."

Sarbanes-Oxley Act of 2002 and codified in Section 10A(m) of the Exchange Act.[32] Section 10A(m) required the Commission, by rule, to direct the national securities exchanges and national securities associations ("SROs") to prohibit the listing of any security of an issuer that is not in compliance with certain enumerated standards regarding issuer audit committees. The Commission adopted new rule 10A-3 under the Exchange Act to implement section 301 of the Sarbanes-Oxley Act.[33] Under section 301 and rule 10A-3, SROs are prohibited from listing any security of an issuer that is not in compliance with the following standards:

- Each member of the audit committee of the issuer must be independent according to specified criteria;

- The audit committee of each issuer must be directly responsible for the appointment, compensation, retention, and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee;

- Each audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters;

- Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and

- Each issuer must provide appropriate funding for the audit committee.

Because section 301 of the Sarbanes-Oxley Act requires the Commission to direct the SROs to prohibit the listing of any security of an issuer that is not in compliance with these audit committee standards, new rule 10A-3 applies only to listed issuers, including

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32 Pub. L. 107-204, 116 Stat. 745 (2002).

33 Investment Company Act Release No. 26001 (Apr. 9, 2003).

listed investment companies. Thus, the new rule generally covers closed-end investment companies, but does not cover most mutual funds.

While many mutual funds already employ some or all of the principles embodied in rule 10A-3, extending similar audit committee requirements to mutual funds is one way to further benefit mutual fund investors. While mutual fund financial statements may, in many cases, be simpler than those of some operating companies, the underlying financial systems, reporting mechanisms, and internal controls are sufficiently complex that a mutual fund would benefit from each of the corporate governance reforms embodied in section 301 of the Sarbanes-Oxley Act and the Commission's implementing rules.

First, fund governance would be enhanced if each member of the audit committee of a mutual fund were required to be independent. As the Commission noted in the release adopting rule 10A-3, an audit committee comprised of independent directors is better situated to assess objectively the quality of the issuer's financial disclosure and the adequacy of internal controls than a committee that is affiliated with management.[34]

Second, a requirement that the audit committee appoint, compensate, retain, and oversee the outside auditor would help to further the objectivity of financial reporting. The auditing process may be compromised when a fund's outside auditors view their main responsibility as serving the fund's management rather than its board or audit committee. We note that the issue of appointment of the fund's independent auditor has

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34 In 2001, the Commission adopted rule 32a-4 under the Investment Company Act to encourage mutual funds to have independent audit committees. Rule 32a-4 exempts a fund from the requirement that selection of the fund's accountant be submitted to shareholders for ratification at the next annual meeting, if the fund has an audit committee composed solely of independent directors.

already been addressed for both listed and non-listed funds by section 202 of the Sarbanes-Oxley Act and the Commission's auditor independence rules. Section 202 and the Commission's rules require that the audit committee of a fund pre-approve all audit, review, or attest engagements required under the securities laws.[35]

Third, requiring the establishment of formal procedures by a fund's audit committee for receiving and handling complaints would serve to facilitate disclosure of questionable practices, encourage proper individual conduct, and alert the audit committee to potential problems before they have serious consequences.

Fourth, a requirement that a fund's audit committee have the authority to engage outside advisors, including counsel, as it determines necessary would assist the audit committee in performing its role effectively. The advice of outside advisors may be necessary to identify potential conflicts of interest and assess the company's disclosure and other compliance obligations with an independent and critical eye.

Fifth, a requirement for the fund to provide appropriate funding to compensate the independent auditor and the advisors employed by the audit committee should further enhance the required standard relating to the audit committee's responsibility to appoint, compensate, retain, and oversee the outside auditor, and add meaning to the standard relating to the audit committee's authority to engage independent advisors.

V. <u>Report on Soft Dollar Arrangements</u>

Section 6 of the Bill would require the Commission to submit to the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs a report on use of soft dollars by investment advisers. The section would

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35 *See* Investment Company Act Release No. 25915 (Jan. 28, 2003); rule 2-01(c)(7) of Regulation S-X. The audit committee is also required to pre-approve all permissible non-audit services.

require that the report cover a number of areas of concern, including conflicts of interest created by soft dollar arrangements, as well as their effect on the transparency of mutual fund expenses. Perhaps most significantly, the section asks the Commission to examine whether Congress should repeal or modify section 28(e) of the Exchange Act.[36]

Section 28(e) provides a "safe harbor" permitting money managers, including investment advisers, to cause a client to pay more than the lowest available commission rate if the money manager determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research provided by the broker.[37] Simply put, section 28(e) permits a money manager to use client brokerage to pay for research that the adviser would otherwise be required to produce himself or pay for in cash out of his own pocket.

According to one recent estimate, the soft dollar market for investment research and related services exceeds $1 billion and is growing.[38] While the research an adviser obtains may benefit the client, it will clearly benefit the adviser, and thus presents an adviser that participates in these arrangements with a conflict of interest. Our current regulatory regime primarily relies on disclosure by advisers of their soft dollar policies and practices. The Staff Responses submitted last week suggested that disclosure alone might not be adequate and suggested the need for Congressional reconsideration of section 28(e).

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[36] We note that the staff has conducted a study that encompassed a number of these issues related to soft dollars. Inspection Report on the Soft Dollar Practices of Broker Dealers, Investment Advisers and Mutual Funds (1998).

[37] Section 28(e) only protects advisers if they pay more than the lowest available commission, and it does not shield a person who exercises investment discretion from charges, for example, that he churned the account, failed to seek the best price, or failed to make required disclosures.

[38] Bear Stearns, Brokers and Asset Managers (June 2003).

The Commission supports including a required report on section 28(e) in this legislative package. Once the reforms called for in the Bill that relate to soft dollars are implemented, the Commission and Congress will need to consider whether further revisions are needed. To accomplish this, policymakers will need current information on soft dollar practices and their impact on the fiduciary obligations of advisers, competition between broker-dealers, the securities markets, and the clients of investment advisers, including mutual funds.

VI. Conclusion

The Commission supports Congressional efforts to improve transparency in mutual fund disclosures, to provide mutual fund investors with the information they need to make informed investment decisions and enhance the mutual fund governance framework. We look forward to working with this Subcommittee to further these important goals.